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IN THE

Supreme Court of the United States

OCTOBER TERM, 1949.

No. 261.

FRANK M. COBB, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit.

REPLY BRIEF FOR PETITIONER.

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The Government concedes that the question presented in this case is an important one of general law.

The Government's opposition to granting the writ is based upon its contentions that a Treasury Regulation should not be disturbed and that the decision of the Court of Appeals is correct. (Respondent's Brief, 9) The Government's brief also states, "There is no conflict of decisions."

The conflict of decisions arises not as between decisions of different Courts of Appeals, but as between the decision

in this case and the controlling decision of this Court in *Trust Under the Will of Bingham, et al.* v. *Commissioner,* 325 U.S. 365. (Decided June 4, 1945.) That there is confusion in the lower Courts is shown in the recent decision in *Lykes* v. *United States,* 84 F. Supp. 537 (June 3, 1949). In that case the District Court for the Southern District of Florida refused to follow the opinion of the Court of Appeals for the Sixth Circuit in the instant case as a proper interpretation of this Court's opinion in the *Bingham* case. The District Court held that attorney fees paid by the taxpayer in contesting a gift tax deficiency are deductible for income tax purposes. The District Court's opinion is printed in the Appendix to this brief, pp.——.

This Court, in the *Bingham* case, made it clear that expenses of management to come within the purview of Section 23(a)(2) need not relate to the production or collection of income. This Court said:

> "Nor is there merit in the court's conclusion that the expenses were not deductible because they were not for the production of income. Section 23(a)(2) provides for two classes of deductions, expenses 'for the production . . . of income' and expenses of 'management, conservation, or maintenance of property held for the production of income.' To read this section as requiring that expenses be paid for the production of income in order to be deductible, is to make unnecessary and to read out of the section the provision for the deduction of expenses of management of property held for the production of income."

It follows that all of the litigation expenses here in question are deductible if they are expenses of "management" or "conservation" of property, whether their expenditure did or did not result in the production of income. Notwithstanding this important and definite teaching of the *Bingham* case, the Government makes this statement:

> ". . . But here, the expenses were not at all attendant upon the production of income; they were, on the contrary, directly connected with the *profitless* separation

> from the taxpayer of some of his property." (Brief for Respondent, 8) (Italics supplied)

The Government also completely loses sight of the fact that the transactions in the *Bingham* case pertained to the administration of a testamentary *gift*. The question was whether certain expenses were allowable deductions, although the same did not result in the production of income but pertained only to acts of "management" in connection with the administration of the trust estate and its distribution to the remaindermen.

The parallel of that situation with the one in this case is striking. The gift *inter vivos* does not require a long period of administration, only the completion of the gift by the satisfaction and discharge of the gift tax liability. The law imposed upon the donor the primary and personal duty to pay the tax. Upon the proposed assessment of a deficiency in such tax by the Commissioner, petitioner employed attorneys to contest it. This was an act of "management" in the discharge of petitioner's duty to pay the tax. The proximate and direct relationship between the making of the gift and the contesting of the tax on the one hand, and the incurring of attorney fees to protect the interests of petitioner, is self-evident. In spite of this, the Government states:

> "But there is no such direct connection between the expenses of resisting gift taxes and the management of the taxpayer's income producing property; nor are the expenses the proximate result of that management." (Respondent's Brief, 6)

No result could be more direct.

Respondent's statement that the deductible expenses "were incurred in 1944" (Brief, 7) is misleading. The facts are that the gift was made in December 1941, and prior to March 15, 1942 the gift tax return was filed and the gift tax was paid. In July 1942 the Government proposed an increase in the tax. Thereupon, taxpayer em-

ployed the attorneys to protest the proposed tax, and when the deficiency was determined in November 1942, the attorneys were directed to file a case in the Tax Court for a redetermination of the deficiency. In December 1943 the Tax Court case was settled and the deficiency was paid. On January 12, 1944 the taxpayer paid his attorneys $2,260.00 as fees for all of their services in connection with the gift tax dispute (R. 18, Stipulation of Facts R. 27, Finding of Facts by Tax Court R. 36). It appears, therefore, that the litigation expenses were incurred in the years 1942 and 1943, and *payment* for the same was made in 1944.

Another important teaching of the *Bingham* case is that within the meaning of Section 23(a)(2) property does not cease to be "held" even though the period of such holding draws to its "expiry" date and such property is being distributed to its new owners. The costs of such distribution are expenses of a function of "management" quite as much as were expenses incurred in producing the income (Bingham, 366, 374, 375). In the case at bar execution and delivery of the deed to the donees in and of itself imposed on the donor the gift tax liability. The effective distribution of the property to the donees required the petitioner to discharge his gift tax liability and to cancel the gift tax lien on the donated property.

The Government seeks to distinguish this case from the *Bingham* decision by relying upon the fact that the taxpayer there had a fiduciary obligation to make the distribution, whereas Mr. Cobb had no obligation to make the gifts. Significantly, the Court of Appeals based its decision upon this ground. A casual examination of fundamentals reveals the fallacy of this argument. Section 23(a)(2) begins: "In the case of an *individual* . . ." It is only by provisions of another section of the Code that this section is made to apply also to trustees. The whole amendment to this section was designed primarily for individuals, to allow them deductions for the expenses of actions which they had no duty to take. As a holder of many securities Mr.

Cobb has no duty to seek the advice of investment counsel, but if he does so his expenses are deductible. The fact that he has freedom of choice in the matter has no relevance whatever. Had the trustee in the *Bingham* case been given discretion concerning the time of distribution and the beneficiaries to whom distribution should be made, it is inconceivable that this Court would have disallowed the claimed deduction on that ground.

As the Government has chosen to argue the merits of the decision below, several brief comments appear in order at this time. The Government has labeled the gifts as "profitless separation from the taxpayer of some of his property." We point out that the Tax Court found that one reason Mr. Cobb made the gifts was to save income taxes. (R. 26) As would be pointed out in detail in argument on the merits, Mr. Cobb's method was to give capital which would produce $5,000.00 per year for each daughter, rather than to give $5,000.0 of his income to each daughter each year after paying his income tax on it. His method left him $27,000.00 annual income, whereas the other method would have left him $2,000.00 annual income. Obviously, he was managing and conserving his property when he made the gifts as well as subsequently when he contested the asserted deficiency.

The Government also asserts, "Taxpayer cannot resist liens on donated property and then seek to attribute the cost of resistance to retained property." This is, of course, a *non sequitur*. The Government itself has stated the facts, (Respondent's Brief, 4): "If the taxpayer had been required to pay the original deficiency claimed, it would have been necessary for him to sell additional income-producing securities." Obviously, the same resistance by taxpayer which removed the liens on the donated property also protected the retained property. One of the grounds of the decision of the Tax Court in the *Bingham* case (2 T. C. 853, 859), and the ground of the dissenting Tax Court judges

in the instant case is that expenses incurred in the protection of one's property from lien are deductible under 23(a)(2). We submit that it is a proper ground.

Conclusion.

It is, therefore, submitted that the petition for writ of certiorari should be granted.

Respectfully submitted,

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September 30, 1949.

APPENDIX.

JOSEPH T. LYKES v. U. S.

(U. S. District Court, Southern District of Florida, Tampa Division, Civil No. 1556-T, June 3, 1949, 84 F. Supp. 537)

Chester Ferguson and Macfarlane, Ferguson, Allison & Kelly, Tampa, Fla., for plaintiff.

Herbert S. Phillips, United States Attorney, Tampa, Fla., for defendant.

De Vane, District Judge:

This is a suit to recover an alleged overpayment of income taxes for the year, 1944. The question presented is whether, under Section 23(a) (2) of the Internal Revenue Code, 26 U. S. C. A. § 23(a) (2), attorney's fees paid by the taxpayer in the year 1944 in the determination of his gift tax liability for the year 1940 are allowable as a deduction from his gross income. The evidence in the case is not in dispute.

Plaintiff is and has been for many years a stockholder in Lykes Brothers, Inc., a family corporation. The stock of the corporation has been closely held throughout its existence and there is not nor has there ever been an open market price for the stock. In the year 1940 plaintiff made gifts of 1000 shares of stock of the corporation, owned by him, to members of his family, as follows:

250 shares to Margaret K. Lykes, his wife
250 shares to Margaret H. Lykes, his daughter
250 shares to Elizabeth L. Lykes, his daughter
250 shares to Joseph T. Lykes, Jr., his son.

It appears from the testimony that one of the daughters had reached her majority at the time of the gifts, but the other two children were minors. All of the children made their home with the taxpayer, were unmarried and neither the wife nor the children took any part in the management of the business of Lykes Brothers, Inc., at the time of the gifts.

The motive for the gifts, as stated in the taxpayer's gift tax return, was love. The taxpayer testified to additional motives, the principal of which was the accepted custom or policy of himself and his brothers to make such gifts to

their children to insure continuity of the ownership and management of the company. The evidence shows this custom had been pursued by other members of the Lykes family, who were blessed with children.

At the time the gift tax return was filed taxpayer valued the stock at $120.00 per share and paid a gift tax thereon in the sum of $13,032.75. The taxpayer testified he took as a guide in determining the value of the stock the only arm's-length transaction of importance during that year, of which he had knowledge, which was the sale of several hundred shares by an executive (not a member of the Lykes family) to other executives of the company. He testified he also took into consideration the hazards then confronting the business and reached the conclusion that the market value established by the sale represented the fair value of the stock at the time.

On March 3, 1944 the Commissioner of Internal Revenue formally notified taxpayer that a determination of his gift tax liability for 1940 disclosed a deficiency of $145,276.50 and a deficiency in that amount was assessed against taxpayer. He also was notified of his right to petition the tax court for a re-determination of such deficiency liability.

Taxpayer engaged K. I. McKay to represent him in this matter and a Petition for Re-determination of the liability was filed with the tax court. After taxpayer's attorney had prepared and filed such Petition and prepared his case for trial, a compromise settlement was reached and the Tax Court, pursuant to stipulation of the parties, found a deficiency in taxpayer's gift tax return in the sum of $15,612.75, which was promptly paid. The taxpayer paid his attorney $7,263.83 in the year 1944 for services in this matter. No question is raised as to the reasonableness of the amount paid for the services rendered. If the payment is a deductible expense from gross income for the year, as taxpayer claims, he is entitled to recover $5,665.78 with interest in this case.

The taxpayer claims that the payment of $7,263.83 as attorney's fees was an allowable deduction under Section 23(a) (2) of the Internal Revenue Code in as much as the payment was an "ordinary and necessary expenses paid or incurred during the taxable year * * * for the management, conservation or maintenance of property held for the production of income." He contends the payment was

made, not as the result of an ordinary contest concerning the valuation of ordinary personal gifts, but that it was a payment of legal expenses incurred to forestall the collection by the Government of an assessment of a tax which was so clearly arbitrary and capricious that, in fact, it had nothing to do with the gift on which it was based. He contends further that had it been successfully enforced against him it would have substantially destroyed his holdings in Lykes Brothers, Inc., and would have confiscated most of the property held by him for the production of income.

The Commissioner contends that the law of the case is clearly stated in Treasury Regulation 111, Section 29.23-(a)15(b) as amended by TD 5513. This Regulation provides that expenses paid or incurred by an individual in the determination of gift tax liability, with certain exceptions not applicable here, are not deductible from gross income, even though property held by taxpayer for the production of income must be sold to satisfy an assessment for such tax liability. It is well established that such Treasury Regulations have the force and effect of law if not in conflict with expressed statutory provisions. *Maryland Casualty Company* v. *U. S.*, 251 U. S. 342, 40 S. Ct. 155 [3 AFTR 3010], 64 L. Ed. 297; *United States* v. *Grimaud*, 220 U. S. 506, 31 S. Ct. 480, 55 L. Ed. 563.

Section 23(a) (2) of the Internal Revenue Code, relied upon by taxpayer, provides:

> "Deductions from gross income. In computing net income there shall be allowed as deductions: * * * (2) Non-trade or non-business expenses. In the case of an individual, all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income."

There is no statute specifically allowing or prohibiting deductions from gross income of attorneys' fees for services rendered in relation to advice or litigation in respect of any Internal Revenue taxes.

Treasury Regulation 111, Section 29.23-(a)-15(b), as amended by T. D. 5513, relied upon by Commissioner, provides:

"Expenses paid or incurred by an individual in the determination of liability for taxes upon his income are deductible. If property is held by an individual for the production of income, amounts expended in determining a property tax imposed with respect to such property during the period when so held are deductible. Expenses paid or incurred by an individual in determining or contesting any liability asserted against him do not become deductible, however, by reason of the fact that property held by him for the production of income may be required to be used or sold for the purpose of satisfying such liability. Thus, expenses paid or incurred by an individual in the determination of gift tax liability, except to the extent that such expenses are allocable to interest on a refund of gift taxes, are not deductible, even though property held by him for the production of income must be sold to satisfy an assessment for such tax liability or even though, in the event of a claim for refund, the amount received will be held by him for the production of income."

The only Appellate Court decision bearing upon the precise question here presented is *Cobb* v. *Commissioner of Internal Revenue*, decided by the U. S. Court of Appeals, Sixth Circuit, 173 F. 2d 711. That court held that under the stipulated and undisputed facts in that case the attorney's fees there paid were not deductible. That case came to the Court of Appeals from a decision of the Tax Court, 10 T. C. 380, which had also disallowed the deduction. The taxpayer in that case, as does the taxpayer here, relied upon *Bingham et al.* v. *Commissioner of Internal Revenue*, 325 U. S. 365, 65 S. Ct. 1232 [33 AFTR 842], 89 L. Ed. 1670, 163 A. L. R. 1175, as supporting his position for the deduction. In the Cobb case the Court of Appeals held that the Bingham case was not controlling and went to considerable pains to point out its reasons for so holding. This court has carefully reviewed these reasons, but finds itself unable to follow them.

This case presents the question, in relationship of the sovereign with its subjects, as to whether Congress has dealt justly with the taxpayer. Congress has imposed gift taxes and has authorized the Commissioner of Internal Revenue to assess an additional gift tax when, in his opin-

ion, there is a deficiency in the gift tax paid by the taxpayer. The Commissioner may do this without giving the taxpayer an opportunity to be heard and the deficiency tax so imposed becomes final upon the taxpayer unless the procedure prescribed by the law is followed, as was done in this case.

To construe the law as giving to the Commissioner the power to assess a taxpayer with a deficiency tax greatly in excess of what he owes and to hold that such law denies to the taxpayer the right to contest such assessment except at his own personal expense, just isn't justice under the law. The statute in question gives the Commissioner no such power and the courts should not permit the Commissioner to write such power into the law by a regulation adopted by him.

The inconsistency of this Treasury Regulation is illustrated by the fact that while it denies the right of the taxpayer to deduct expenses paid or incurred in the determination of a gift tax assessment it authorizes the deduction of expenses incurred in litigation to determine whether the expenses paid or incurred in the gift tax assessment are deductible.

In this connection it is noted that in the Bingham case the same position was taken by the Commissioner as is here taken; that is, that a Treasury Regulation prohibited the deduction.

The Supreme Court in the Bingham case, said [325 U. S. 365, 65 S. Ct. 1238]:

> "So far as this regulation purports to deny deductions of litigation expenses unless it is to produce income, it is not in conformity with the statute • • • ."

This court has reached the opinion that this is also true in this case and the court finds and holds that the Treasury Regulation is in conflict with the expressed statutory provision authorizing the deduction.

A judgment will be entered in favor of the taxpayer, in conformity with this Memorandum Decision.